

warrants for trading pursuant to the Generic Warrant Listing Standards.²⁸

B. Customer Protection

Special customer protection concerns are presented by Tech 50 Index warrants because they are leveraged derivative securities. The CBOE has addressed these concerns, however, by applying the special suitability, account approval, disclosure, and compliance requirements adopted in the Generic Warrant Listing Standards Approval Order. Moreover, the CBOE plans to distribute a circular to its membership identifying the specific risks associated with Tech 50 Index warrants. Finally, pursuant to the Exchange's listing guidelines, only substantial companies capable of meeting CBOE index warrant issuer standards will be eligible to issue Index warrants.

C. Surveillance

The Commission believes that a surveillance sharing agreement between an exchange proposing to list a security index derivative product and the exchange(s) trading the securities underlying the derivative product is an important measure for surveillance of the derivative and underlying securities markets. Such agreements ensure the availability of information necessary to detect and deter potential manipulations and other trading abuses, thereby making the security index product less readily susceptible to manipulation.²⁹ In this regard, the CBOE, NYSE, and NASD are all members of the Intermarket Surveillance Group, which provides for the exchange of all necessary surveillance information.³⁰

²⁸ See *supra* note 7 and accompanying text.

²⁹ Securities Exchange Act Release No. 31243 (September 28, 1992), 57 FR 45849 (October 5, 1992).

³⁰ The Intermarket Surveillance Group ("ISG") was formed on July 14, 1983 to, among other things, coordinate more effectively surveillance and investigative information sharing arrangements in the stock and options markets. See Intermarket Surveillance Group Agreement, July 14, 1983. The most recent amendment to the ISG Agreement, which incorporates the original agreement and all amendments made thereafter, was signed by ISG members on January 29, 1990. See Second Amendment to the Intermarket Surveillance Group Agreement, January 29, 1990. The members of the ISG are: the American Stock Exchange, Inc.; the Boston Stock Exchange, Inc.; CBOE; the Chicago Stock Exchange Inc.; the National Association of Securities Dealers, Inc. ("NASD"); the NYSE; the Pacific Stock Exchange, Inc.; and the Philadelphia Stock Exchange, Inc. Because of potential opportunities for trading abuses involving stock index futures, stock options, and the underlying stock and the need for greater sharing of surveillance information for these potential intermarket trading abuses, the major stock index futures exchanges (e.g., the Chicago Mercantile Exchange and the Chicago Board of Trade) joined the ISG as affiliate members in 1990.

D. Market Impact

The Commission believes that the listing and trading of Tech 50 Index warrants on the CBOE will not adversely impact the underlying securities. First, the existing index warrants surveillance procedures of the CBOE will apply to warrants on the Index. In addition, the Commission notes that the Index is broad-based and diversified and includes highly capitalized securities that are actively traded. Additionally, the CBOE has established reasonable position and exercise limits for stock index warrants, which will serve to minimize potential manipulation and other market impact concerns.

It Therefore is Ordered, pursuant to Section 19(b) (2) of the Act,³¹ that the proposed rule change (SR-CBOE-95-38) is approved, as amended.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³²

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[Release No. 34-36374; File No. SR-NASD-95-41]

Self-Regulatory Organizations; Notice of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to an Expansion of the NASD's Short-Sale Rule to Include Nasdaq SmallCap Market Securities

October 16, 1995.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on September 22, 1995, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The NASD is proposing to expand the scope of its short-sale rule to include Nasdaq SmallCap Market[®] ("SCM") securities. Consistent with the current short-sale rule applicable to Nasdaq National Market[®] ("NNM") securities, the NASD proposes to implement the

short-sale rule for SCM securities on a pilot basis until June 3, 1996.

The text of the proposed rule change is available at the Office of the Secretary of the NASD and at the Commission.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

On June 29, 1994, the SEC approved a new short sale rule for NNM securities traded on The Nasdaq Stock MarketSM ("Nasdaq").² The NASD's short sale rule, which became effective on September 6, 1994 for an eighteen-month pilot period,³ prohibits member firms from effecting short sales⁴ at or below the current inside bid as disseminated by the Nasdaq system whenever that bid is lower than the previous inside bid.

Nasdaq calculates the best bid from all market makers in the security (including bids on behalf of exchanges trading Nasdaq securities on an unlisted trading privileges basis), and disseminates symbols to denote whether the current inside bid is an "up bid" or a "down bid." Specifically, and "up bid" is denoted by a green "up" arrow symbol and a "down bid" is denoted by a red "down" arrow. Accordingly, absent and exemption from the rule, a member can not effect a short sale of or below the inside bid in a security in its proprietary account or an account of a customer if there is a red arrow next to

² See Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994).

³ The Commission subsequently approved a NASD proposal extending the pilot period until June 3, 1996. Securities Exchange Act Release No. 36171 (Aug. 30, 1995), 60 FR 46651 (Sept. 7, 1995).

⁴ A short sale is a sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller. To determine whether a sale is a short sale members must adhere to the definition of a "short sale" contained in SEC Rule 3b-3, which rule is incorporated into Nasdaq's short sale rule by Article III, Section 48(l)(1) of the NASD Rules of Fair Practice.

³¹ 15 U.S.C. § 78s(b) (2) (1988).

³² 17 CFR 200.30-3(a) (12) (1994) ≤

¹ 15 U.S.C. § 78s(b)(1) (1988).

the security's symbol on the screen. In order to effect a "legal" short sale on a down bid, the short sale must be executed at a price at least a $\frac{1}{16}$ th of a point above the current inside bid. Conversely, if the security's symbol has a green up arrow next to it, members can effect short sales in the security without any restrictions. The rule is in effect during normal domestic market hours (9:30 a.m. to 4:00 p.m., Eastern Standard Time).

In order to ensure that market maker activities that provide liquidity and continuity to the market are not adversely constrained when the short sale rule is invoked, the rule provides an exemption to "qualified" Nasdaq market makers. Even if a market maker is able to avail itself of the qualified market maker exemption, it can only utilize the exemption from the short sale rule for transactions that are made in connection with bona fide market making activity. If a market maker does not satisfy the requirements for a qualified market maker, it can remain a market maker in the Nasdaq system, however, it can not take advantage of the exemption from the rule.

Until December 1, 1995, a "qualified" Nasdaq market maker is defined to be a registered market maker that has entered quotations in the relevant security into the Nasdaq system on an uninterrupted basis for the preceding 20 business days (the "20-day" test). The "20-day" test is applied to initial public offerings, secondary offerings, and merger and acquisition situations in the following manner:

- for initial public offerings, a market maker may immediately become a qualified market maker in an IPO by immediately registering (by 9:30 of the business day after completion of the offering) and entering quotations in the issue. However, if the market maker withdraws from the security on an unexcused basis within the first 20 days after the offering, it will not be eligible for designation as a qualified market maker in any subsequent IPO for the next 10 business days following the unexcused withdrawal.
- For secondary offerings, unless a market maker was registered in a security prior to the time a secondary offering in that stock has been publicly announced or a registration statement has been filed, it cannot become a qualified market maker in the stock unless the secondary offering has become effective and the market maker has been registered in the security and maintained quotations without interruption for 40 calendar days.
- In merger and acquisition situations, after a merger or acquisition

involving an exchange of stock has been publicly announced and not yet consummated or terminated, a market maker may register and begin entering quotations in either or both of the two affected securities and immediately become a qualified market maker in either or both of the issues. However, if the market maker withdraws on an unexcused basis from any stock in which it has so registered within 20 days of so registering, the market maker will not be eligible for immediate designation as a qualified market maker for any merger or acquisition announced within three months subsequent to such unexcused withdrawal.

From December 1, 1995 to June 3, 1996, a "qualified" market maker must satisfy the criteria for a "Primary Nasdaq Market Maker" ("PMM") found in new Section 49 of the NASD Rules of Fair Practice.⁵ After December 1, 1995, a "P" indicator will be displayed next to every qualified market maker that is exempt from the rule according to the PMM standards. To qualify as a PMM, market makers must satisfy at least two of the following four criteria:

- (1) The market maker must be at the best bid or best offer as shown on the Nasdaq system no less than 35 percent of the time;
- (2) The market maker must maintain a spread no greater than 102 percent of the average dealer spread;
- (3) No more than 50 percent of the market maker's quotation updates may occur without being accompanied by a trade execution of at least one unit of trading; or
- (4) The market maker executes $1\frac{1}{2}$ times its "proportionate" volume in the stock.⁶

The review period for satisfaction of the Primary Market Maker performance standards is one calendar month. If a Primary market maker has not satisfied the threshold standards after a particular review period, the Primary Market Maker designation will be removed commencing on the next business day following notice of failure to comply with the standards. Market makers may requalify for designation as a Primary Market Maker by satisfying the threshold standards for the next review period.

⁵ The PMM standards were originally scheduled to go into effect on September 6, 1995; however, the implementation date for the standards was postponed to December 1, 1995. Securities Exchange Act Release No. 36171 (Aug. 30, 1995), 60 FR 46651 (Sept. 7, 1995).

⁶ For example, if there are 10 market makers in a stock, each dealer's proportionate share volume would be 10 percent; therefore, $1\frac{1}{2}$ times proportionate share volume would mean 15 percent of overall volume.

If a market maker is a PMM in 80 percent or more of the securities in which it has registered, it may immediately become a PMM (i.e., a qualified market maker) in a NNM security by registering and entering quotations in that issue. If the market maker is not a PMM in at least 80 percent of its stocks, it may qualify as a PMM in that stock if the market maker registers in the stock but does not enter quotes for five days or the market maker registers in the stock as a regular Nasdaq market maker and satisfies the qualification criteria for the next review period. In addition, the PMM standards are applied to initial public offerings, secondary offerings, and merger and acquisition situations in the following manner:

- For initial public offerings, a market maker may immediately become a PMM in an IPO issue by immediately registering and entering quotations in the issue, provided it has obtained status in 80 percent or more of the stocks in which it has registered. However, if at the end of the first review period a market maker has failed to satisfy the qualification criteria or has withdrawn on an unexcused basis from the security, it is prohibited from becoming a PMM in any other IPO for the next 10 business days.
- For secondary offerings, unless market maker was registered in a security prior to the time a secondary offering in that stock has been publicly announced or a registration statement has been filed, it cannot become a PMM in the stock unless the secondary offering has become effective and the market maker has satisfied the PMM standards between the time the market maker registered in the security and the time the offering became effective or the market maker has satisfied the PMM standards for 40 calendar days.
- In merger and acquisition situations, after a merger or acquisition is announced, a market maker that is a PMM in one stock may immediately become a PMM in the other stock by registering and entering quotations in that issue. In addition, if a market maker is a PMM in 80 percent of the stocks it makes a market in, it may register and immediately become a PMM in both issues.

In order to reduce compliance burdens for members, the NASD's short sale rule also incorporates the exemptions in SEC Rule 10a-1 that are relevant to trading on Nasdaq. Specifically the rule exempts:

- Sales by a broker-dealer for an account in which it has no interest and that are marked long;

- Any sale by a market maker to offset odd-lot orders of customers;

- Any sale by any person, for an account in which he has an interest, if such person owns the security sold and intends to deliver such securities as soon as possible without undo inconvenience or expense;

- Sales by a member to liquidate a long position which is less than a round lot, provided the sale does not change the member's position by more than one unit of trading (100 shares);

- Short sales effected by a person in a special arbitrage account if the person effecting the short sale then owns another security by virtue of which the person is, or presently will be, entitled to acquire an equivalent number of securities of the same class of securities sold; provided such sale, or the purchase which such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned and that such right of acquisition was originally attached to or represented by another security or was issued to all the holders of any such class of securities of the issuer;

- Short sales effected by a person in a special international arbitrage account for the bona fide purpose of profiting from a current difference between the price of such security on a securities market not within or subject to the jurisdiction of the United States and on such a securities market subject to the jurisdiction of the United States; provided the person at the time of such sale knows or, by virtue of information currently received, has reasonable grounds to believe that an offering enabling a person to cover such sale is then available to the person in such foreign securities markets and intends to accept such offer immediately; and

- Short sales by an underwriter or any member of the distribution syndicate in connection with the over-allotment of securities, or any lay-off sale by such a person in connection with a distribution of securities rights pursuant to SEC Rule 10b-18 or a standby underwriting commitment.

The rule also provides that a member not currently registered as a Nasdaq market maker in a security that has acquired the security while acting in the capacity of a block positioner shall be deemed to own such security for the purposes of the rule notwithstanding that such member may not have a net long position in such security if and to the extent that such member's short position in such security is subject to one or more offsetting positions created in the course of bona fide arbitrage, risk

arbitrage, or bona fide hedge activities.⁷ The rule also contains certain limited exemptions for options market makers and warrant market makers.

As with the short-sale rule for NNM securities, which the Commission has approved on a pilot basis, the NASD believes imposing a short-sale rule on SCM securities will promote the maintenance of fair and orderly markets and the protection of investors. Specifically, by helping to prevent speculative short selling in SCM securities from rapidly accelerating a decline in the price of a security and a form of manipulation known as "bear raiding" or "piling on,"⁸ the NASD believes its proposal will enhance the market for SCM securities. The NASD also is concerned that in instances of extreme intra-day volatility in SCM securities that the ability of existing shareholders to sell their stock may be inhibited because professional short sellers are in the market before them, exacerbating downward pressure on stocks and reducing overall liquidity in the marketplace. The NASD believes that expanding the scope of its short-sale rule to include SCM securities will help to curb abusive short selling, reducing the exposure of the Nasdaq market to manipulation and excessive intra-day volatility. Without a short-sale rule for SCM securities, the NASD also believes issuers of SCM securities may be disadvantaged in offerings on Nasdaq because the increased potential for short selling may artificially affect the prices at which such offerings are conducted. In this regard, members report that their investment banking departments may recommend exchange listings for SCM securities because of the lack of adequate short sale regulation in the Nasdaq market. Accordingly, the NASD believes that the proposed modification to the NASD's short-sale rule will assure both issuers and investors in SCM securities that they are subject to at least equivalent protection from predatory short selling in the Nasdaq market as they are on an exchange.

In addition, because the short-sale rule applicable to SCM securities will be identical to the short-sale rule applicable to NNM securities, the NASD

⁷ The NASD also has interpreted its short-sale rule to provide exemptions consistent with SEC staff interpretations of SEC Rule 10a-1 dealing with the liquidation of index arbitrage positions and trading in foreign securities (the so-called "international equalizing exemption"). See Securities Exchange Act Release No. 30772 (June 3, 1992), 57 FR 26891 (June 16, 1992).

⁸ "Piling on" occurs all when short sellers exert substantial selling pressure on a stock with the intent to dominate and demoralize the market for that stock, forcing the price to drop precipitously, frequently with a single trading day.

believes its proposal is structured in a manner to best prevent abusive short sales while also preserving the depth and liquidity of the markets for SCM securities. In this connection, the NASD notes that the Nasdaq Stock Market provides an efficient and liquid trading environment through quote competition among competing market makers. Crucial to the maintenance of this competitive market structure is the requirement for market makers to display firm two-sided quotations. Moreover, the very nature of the competitive market maker system requires dealers to take substantial inventory positions. Accordingly, the NASD believes application of a short-sale rule to SCM securities without an exemption for qualified market makers would result in degradation of the accuracy and reliability of quotations.

The NASD also believes qualified market makers in SCM securities must be permitted the flexibility to sell short when necessary so that they will be able to adjust quickly to market movements and control the risks associated with market making, while continuing to provide the maximum possible liquidity. The ability to manage risk with short positions is fundamental to market maker performance. Market makers need the constant ability to effect short sales to "reliquefy" their positions throughout the trading day. If a short-sale rule were to impact adversely their ability to manage risk, dealers may be forced to reduce their market making support for the SCM securities in which they currently make markets.⁹

Finally, the NASD believes that adoption of a short-sale rule for SCM securities will enhance the Nasdaq Stock Market's ability to compete with exchange primary markets for listings of SCM securities. From a competitive standpoint, the primary exchanges regularly use the lack of a short-sale rule for SCM securities as an argument to try to persuade companies to list on their exchange. Adoption of a short-sale rule for SCM securities will further emphasize to shareholders that Nasdaq provides equivalent short-sale protection to the investing public through rules that are fair, equitable, and consistent with the operation of a quality marketplace.

The NASD believes the proposed rule change is consistent with Sections 15A(b) (6) and (9), Section 11A(a)(1)(C)(i), and Section 11A(c)(1)(F)

⁹ Based on data for the month of August 1995, 73 percent of the market making positions in Nasdaq SmallCap securities would have satisfied the PMM standards.

of the Act. Section 15A(b)(6) requires that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and in general to protect investors and the public interest. The NASD believes that the proposed short-sale rule for SCM securities is consistent with each of these requirements. First, the NASD's proposal is premised on the same anti-manipulation concerns that were relied upon by the SEC to promulgate a short-sale rule for exchange-listed securities, SEC Rule 10a-1. Second, the short-sale rule for SCM securities will promote just and equitable principles of trade by permitting long sellers access to market prices at any time, while requiring short sellers in a declining market to execute their short sales above the bid or wait for an up bid, similar to the constraints placed upon short sellers of exchange-listed securities. Third, the proposal removes impediments to a free and open market for long sellers and ensures liquidity at bid prices that might otherwise be usurped by short sellers. Finally, since the immediate beneficiaries of a short-sale rule for SCM securities are the shareholders who own stock, the NASD believes its proposal is consistent with the protection of investors and the public interest.

Section 15A(b)(9) of the Act requires that the NASD's rules not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. The NASD acknowledges that a short-sale rule applicable to SCM securities does impose burdens and restrictions on members and their customers where there were none before, but believes that these burdens and restrictions are appropriate and necessary to ensure the standing of long sellers in the marketplace and the integrity of the Nasdaq market. This concern with market integrity for existing shareholders has always been paramount in exchange markets and the NASD believes it is now appropriate to extend the same protections to shareholders in SCM securities as well.

Section 11A(a)(1)(C)(i) sets out the economically efficient execution of securities transactions as an objective of a national market system for securities. The NASD's proposed short-sale rule for SCM securities would operate to level the playing field between investors and short sellers by enabling those investors with long positions in a security to liquidate their positions at any time, at

any price, while permitting short sellers access to bid prices when that access will not exacerbate downward pressure in the stock, thus promoting the efficiency of the Nasdaq market. Moreover, the NASD believes that the primary market maker qualifications are critical to ensuring that the proposed rule operates effectively and should have the additional benefit of providing incentives for improved market maker performance in SCM securities.

Section 11A(c)(1)(F) assures "equal regulation of all markets for qualified securities and all exchange members, brokers, and dealers effecting transactions in such securities."¹⁰ The NASD believes that approval of the proposed short-sale rule for SCM securities will result in equivalent short sale regulation for exchange-listed securities and SCM securities.

B. Self-Regulatory Organization's Statement on Burden on Competition

The NASD believes that the proposed rule change will not result in any burden on competition that is not necessary or appropriate in furtherance of purposes of the Act. The NASD believes the PMM standards that would be applicable to market makers in Nasdaq SmallCap securities are designed in a manner to permit market makers of all sizes to meet the standards. Moreover, it is important to note that market makers in Nasdaq SmallCap securities that do not meet the standards will still be permitted to remain registered market makers in these securities. Finally, the NASD is hopeful that the proposed criteria will raise overall the quality of market maker participation in Nasdaq SmallCap securities, thereby promoting competition in the market for these securities.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

The NASD has neither solicited nor received comments on the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or

(ii) as to which the NASD consents, the Commission will:

A. By order approve such proposed rule change, or

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File Number SR-NASD-95-41 and should be submitted by November 13, 1995.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority,¹¹

Margaret H. McFarland,
Deputy Secretary.

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[Release No. 34-36378; International Series Release No. 869; File No. SR-NYSE-95-29]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. Relating to the Specifications and Content Outline for the Canadian Module of the General Securities Registered Representative Examination (Series 37)

October 16, 1995.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on September 18, 1995, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule

¹¹ 17 CFR 200.30-3(a)(12) (1994).

¹ 15 U.S.C. 78s(b)(1).

¹⁰ 15 U.S.C. § 78k-1(c)(1)(F).